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Case No. 4349-CC

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE THE DOW CHEMICAL COMPANY DERIVATIVE LITIGATION, Plaintiff.	))))))	CONSOLIDATED C.A. No. 4349-CC

DEFENDANTS' REPLY MEMORANDUM
<u>IN SUPPORT OF THEIR MOTION TO DISMISS</u>

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INTRODUCTION

In their response to defendant's Motion to Dismiss, plaintiffs have quietly abandoned Count I of their complaint, which accuses three officers and three directors of insider trading. Defendants demonstrated in their opening brief (at 21-27) that plaintiffs' allegations of insider trading are nonsensical on their face and, in any event, do not meet the requirements of Rule 23.1. Plaintiffs have offered no response to that argument and thus Count I should be dismissed.[1]

Plaintiffs have also not responded to defendants' arguments that they failed to meet their burden of pleading demand futility with respect to the *Caremark* claims they assert against the directors for (i) failing to identify and stop the supposed insider trading, (ii) failing to prevent the payment of allegedly excessive and wasteful compensation to unidentified officers and directors, and (iii) failing to detect and prevent alleged bribery in connection with the K-Dow Joint Venture Transaction. Although plaintiffs allude to these allegations in their response, they offer no answer to defendants' demand futility arguments with respect to any of these claims. Accordingly, those claims should also be dismissed.[2]

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[1] Defendants Michael Gambrell, William Banholzer and David E. Kepler are named only as defendants with respect to Count I and thus should be dismissed from the action.

[2] Plaintiffs refer to their waste claim only once in their brief, at page 26, when they repeat the allegations in ¶ 134 of the complaint. Similarly, they refer to the alleged failure to detect insider trading only once in passing, at page 25. Plaintiffs feature their allegations concerning supposed bribery in Kuwait more prominently, in order to cast the K-Dow transaction in a sinister light. *See, e.g.*, Pl. Br. at 5. But they offer no response in the Argument section of their brief to defendants' argument (at 27-29) that plaintiffs have failed to allege any particularized facts suggesting that there was actually any misconduct on the part of Dow's management, let alone any "red flags" that could provide the basis for concluding that the directors consciously ignored their duty to prevent such misconduct.

After the claims that plaintiffs have not even tried to defend are stripped away, all that remains is plaintiffs' attack on the risk-benefit analysis the Dow Board made in deciding to enter into the R&H Merger Agreement. As this Court held in *Citigroup*, however, directors cannot be sued for making business judgments that shareholders claim, in hindsight, involved too much risk. A core purpose of the business judgment rule is to protect directors from precisely this type of judicial second-guessing, to ensure that disinterested and independent directors (as all of the directors were in this case) will be able to make business decisions that involve risks without fear that they will be held liable if those decisions turn out badly.[3]

Recognizing that they cannot meet their burden of pleading demand futility by attacking the wisdom of entering into the R&H Merger Agreement, plaintiffs have tried to turn this into a misrepresentation case. Plaintiffs argue that the Dow Board not only took an excessive risk in entering into the R&H Merger Agreement, but also allowed Dow's senior management to conceal that risk by supposedly misrepresenting the connection between the R&H merger and the K-Dow transaction. The linchpin of plaintiffs' claim — repeated over and over throughout their response — is their assertion that (i) Dow's senior management publicly represented that the R&H acquisition "did not depend in any way" on the completion of the K-Dow transaction, when in fact (ii) the R&H acquisition was entirely dependent upon closing the

[3] By addressing the legal arguments necessary to defeat plaintiffs' claims, Dow is not in any way suggesting that the acquisition of R&H has fallen short of being a business success. Quite the contrary. Dow's acquisition of R&H is already proving to be very successful. Within three months of the close of the acquisition, Dow had achieved 70% of its $1.3 billion twelve-month cost synergy target. In addition, Dow has improved its earnings profile with the acquisition. With the addition of R&H businesses and product lines, two-thirds of Dow is now focused on markets with higher and more sustainable margins. As a result of this transformation, Dow is becoming a more consistent earnings growth company and, in turn, more resistant to earnings fluctuations brought about by the chemical cycle. *See also* Compl. ¶¶ 44-45 (describing Dow's transformational strategy and agreeing that it was "sound").

K-Dow transaction. *See, e.g.,* Pl. Br. at 1, 5, 6, 8, 19, 20. Plaintiffs claim that they know there was a misrepresentation because, in the subsequent litigation with R&H, Dow was forced to "judicially admit" that "cash receipts from the K-Dow deal were, *all along, to be the primary component* of financing through which Dow could complete the R&H merger." Pl. Br. at 6 (emphasis in original).

As demonstrated in Part I below, plaintiffs' theory that the R&H acquisition was, from the very beginning, entirely dependent on closing the K-Dow transaction is based on an egregious misstatement of plaintiffs' own allegations, and of the pleading in the R&H/Dow suit (the "Answer") upon which plaintiffs rely. Because that is the central premise on which plaintiffs' entire complaint is built, that is enough, in and of itself, to require dismissal of the complaint. In addition, however, plaintiffs have failed to demonstrate that they meet *any* of the requirements for pleading demand futility, either under *Aronson* or *Rales.* Accordingly, plaintiffs' entire complaint should be dismissed for failure to properly plead demand futility.[4]

ARGUMENT

I. THE CENTRAL PREMISE OF PLAINTIFFS' RESPONSE IS DEMONSTRABLY FALSE AND UNSUPPORTED BY THE ALLEGATIONS OF PLAINTIFFS' OWN COMPLAINT.

The theory of plaintiffs' case, as described in their response, is that Dow wrongfully committed to the R&H merger, because it knew it could not consummate that transaction without the proceeds from the K-Dow transaction. That theory is utterly and demonstrably false. Plaintiffs claim (at 6) that Dow "judicially admitted" in its Answer to

[4] Plaintiffs imply (at 3) that defendants' reliance on Rule 23.1, rather than Rule 12(b)(6), somehow suggests a weakness in their position. But demand futility is logically the first issue and if plaintiffs cannot succeed under the heightened pleading requirements of Rule 23.1 (as they cannot in this case), there is no need to proceed to an analysis of the merits of the claim.

R&H's complaint that the $9 billion it expected to realize from the K-Dow transaction was "all along, to be the primary component of financing through which Dow could complete the R&H Merger." From that characterization, plaintiffs leap to the conclusion that Dow's senior management and directors knew from the moment the R&H merger agreement was signed that they would not be able to close that deal unless they first closed the K-Dow transaction — and that they lied about the linkage between the two deals to cover up the risk Dow was taking.

Contrary to plaintiffs' argument, there is no conflict between Dow's description of the financing for the R&H transaction when the merger was announced in July 2008 and its description in its February 2009 Answer in the Dow/R&H litigation. Plaintiffs imply that Dow's senior management concealed the fact that the K-Dow transaction was one of the financing sources it was looking to in order to close the R&H transaction. But it was no secret that Dow planned to use the proceeds of that transaction to partially fund the R&H acquisition.[5] In fact, as plaintiffs allege, after a renegotiated version of the K-Dow deal was signed at the end of November 2008, Dow's CEO, Andrew Liveris, was quoted as saying that "[w]e have effectively set the stage for our next major landmark — completing the proposed acquisition of R&H in early 2009." Compl. ¶ 62. When Dow's senior management was asked in July 2008 whether Dow was "counting on" closing the K-Dow transaction first in order to be able to fund the R&H

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[5] In ruling on plaintiffs' claims that there were misrepresentations, the Court can take judicial notice of the statements that Dow made when the merger was announced. *See In re Santa Fe Pac. Corp. Shareholder Litig.*, 669 A.2d 59, 69 (Del. 1995). Attached hereto as Ex. A is a slide from the July 10, 2008 Dow presentation on the R&H merger, which is available on Dow's website. That slide summarized the financing for the deal under the heading "Retains Financial Flexibility" and lists under the bullet "Attractive and diverse transaction funding": "deploy proceeds from PIC joint venture"; "Equity investment by Bershire Hathaway and Kuwait Investment Authority"; and "Debt funding (bridge) provided by Citi, Merrill Lynch and Morgan Stanley." Thus, on the day the transaction was announced, Dow disclosed its intention to use the proceeds from the K-Dow transaction to finance the R&H acquisition.

acquisition, no one denied that Dow was planning on using the proceeds from the K-Dow transaction. Instead, they simply stated that the R&H deal was not "contingent" on K-Dow closing, that they were not "counting on" the proceeds of the K-Dow transaction to close the R&H deal, and that "[w]e can do this deal without the Kuwait money, and we will stay at investment grade." Compl. ¶ 57.

Nothing Dow said in the Answer it filed six months later contradicts these statements. As the Answer clearly states, the K-Dow transaction was one of three planned sources of financing for the R&H merger — the other two being $4 billion of equity commitments and a $13 billion bridge loan facility. Compl. ¶ 88, Answer at 8. Thus, Dow had potential financing sources totaling $26.5 billion, far more than the $15.7 billion of cash that Dow needed to complete the $19 billion R&H merger.[6] In addition, it was expected that the merged entity would have significant "financial flexibility" (Answ. ¶ 8), and it was always anticipated that the merged entity would utilize that financial flexibility. For example, even if the K-Dow transaction had closed, Dow would have needed to borrow under the bridge facility to make up for the difference between the cash required to complete the merger ($15.7 billion) and the proceeds of the K-Dow transaction plus the equity investment ($13.5 billion). Since Dow had strong earnings ($1.7 billion in the first half of 2008) and attractive assets (including the R&H assets it would acquire in the merger), Dow believed in July 2008 — when it executed that R&H merger agreement — that it could consummate the merger and maintain its investment grade rating *even if the K-Dow transaction was delayed or did not close at all.*

6 In addition to paying approximately $15.7 billion in cash, Dow was also assuming approximately $3.2 billion of R&H debt, for a total merger price of nearly $19 billion.

There is no support — none — for plaintiffs' conclusory assertion that Dow knew (or believed) in July 2008 that it would not be able to complete the R&H merger without the proceeds from the K-Dow transaction. Plaintiffs cite ¶¶ 10 and 11 of Dow's Answer in support of their theory. But those paragraphs simply refer to the three sources of financing upon which Dow was relying and highlight the "multiple layers of financing" and "flexibility" that Dow believed it had. Nowhere in its Answer did Dow even remotely suggest that it thought when it signed the R&H Merger Agreement in the summer of 2008 that it would be unable to close the R&H transaction unless the K-Dow transaction closed first. On the contrary, the Answer makes clear that it was the unprecedented changes in the world economy *after* the R&H merger was signed that created Dow's financial bind, *not* a risk that Dow could have foreseen in July 2008.

That Dow's Board refused to close the R&H transaction after the K-Dow transaction was cancelled also does not give rise to any inference that Dow knew all along that one deal was contingent on the other. Plaintiffs blithely ignore the fact that, in the six months between July 2008 and January 2009, there were catastrophic changes in the U.S. and world economies. The credit markets crashed in September after Lehman Brothers failed. The chemical industry nosedived in December and the first quarter of 2009, in light of an unprecedented destruction of the demand for chemical products. Dow's business plummeted to the point that it suffered a $1.6 billion loss in the fourth quarter of 2008. Its credit ratings were cut. If Dow had closed the R&H transaction by simply drawing down on the $13 billion bridge loan it had arranged, it would have lost its investment grade credit rating and triggered an almost immediate default under the term loan and cross-defaults under other credit agreements. *See* Defts. Opening Br. at 7-9. It was in light of these unforeseen and unforeseeable circumstances that the Dow Board concluded that it would be imprudent to close the R&H transaction absent a change in the financing arrangements that would preserve Dow's investment grade credit rating.

As this Court observed in *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009), the fact that a business decision "in hindsight, turned out poorly for the Company" does not provide a basis for launching a shareholder derivative action. Yet that is all plaintiffs have alleged here. Stripped of plaintiffs' rhetoric, their claim is that Dow's directors should be held liable because they failed to foresee the collapse of the K-Dow transaction and the global meltdown that temporarily derailed Dow's plans to finance the R&H acquisition. But, as this Court explained in *Citigroup*, "[t]he essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return." *Id.* at 126. Here, the Dow Board made a business judgment about the trade-off between the return to be gained by acquiring R&H and the risk imposed by R&H's demand that all of the competing bidders agree to an "ironclad" merger agreement without a financing condition. However that trade-off may ultimately turn out, it cannot provide a basis for a shareholder derivative action alleging a breach of fiduciary duty.

II. PLAINTIFFS HAVE NOT PROPERLY PLEADED DEMAND FUTILITY WITH RESPECT TO THEIR CLAIM THAT THE DIRECTORS ACTED IN BAD FAITH IN APPROVING THE R&H TRANSACTION.

The parties agree that *Aronson* applies in judging whether plaintiffs have properly pleaded demand futility with respect to their claim that the directors breached their fiduciary duties in approving the R&H transaction in the summer of 2008. To meet their burden under *Aronson*, plaintiffs must plead particularized facts raising a reasonable doubt (i) that a majority of the directors who approved the transaction were disinterested and independent or (ii) that the challenged transaction was the product of a valid exercise of business judgment. Plaintiffs claim that they have met their burden under both prongs. But, as demonstrated below, plaintiffs' arguments are all based on a distortion of the *Aronson* standards.

A. Plaintiffs' Claim That They Meet The First Aronson Prong Is Based On A Misunderstanding Of the Concept of Independence.

The parties agree that *Aronson's* first prong requires plaintiffs to plead particularized facts that raise a reasonable doubt that a majority of the directors who approved the transaction in question were disinterested and independent. Plaintiffs' argument that they have met this burden is based on a complete misunderstanding of the concept of "independence" under *Aronson.*

As demonstrated in defendants' opening brief, to meet their burden under *Aronson's* first prong, plaintiffs would have to plead particularized facts showing that at least six of the twelve Dow directors either (i) had personal interests that were not aligned with Dow's interests in the R&H transaction or (ii) lacked independence because, although not directly interested themselves, they were dominated and controlled by someone else who was interested in the transaction. *See* Deft. Opening Br. at 14-15 (citing *Brehm v. Eisner*, 746 A.2d 244, 257-58 (Del. 2000)). At page 12 of their brief, plaintiffs seem to agree with this proposition. Two pages later, however, plaintiffs argue for a different and entirely erroneous standard, under which a director could be disqualified under the first *Aronson* prong simply because he or she "is not independent of other directors or the company."

Under plaintiffs' theory, "independence" does not depend on whether the director is dominated by someone with a personal interest in the transaction. Instead, it is a free-floating concept under which anyone who could be deemed to be beholden either to the company or to any other director is somehow presumed to be unable to make a proper business judgment — even if there is not *a single director* who has any personal interest in the matter at issue. Thus, plaintiffs argue that they have shown that the three directors who are not "independent" under New York Stock Exchange standards (Liveris, Merszei and Allemang) were not "independent" under the first *Aronson* prong simply because they depend for their livelihood on the salaries and other compensation they receive from Dow. Pl. Br. at 15. Plaintiffs then go on to argue that they have alleged sufficient facts to show that Mr. Liveris dominated and controlled at least three of the outside directors, thus meeting their burden under the first *Aronson* prong. This argument is based on a fundamental misunderstanding of the *Aronson* test.

The cases plaintiffs cite do not support their erroneous view that a director can be disqualified under the first *Aronson* prong simply because he or she is a management director and therefore is dependent on the company to earn a living. Plaintiffs rely on *Rales*, where the Delaware Supreme Court held that a management director was not independent. But they miss a crucial step in the *Rales* analysis. In that case, the Court first determined that the Rales brothers and another director were "interested" because they were subject to a substantial likelihood of liability for their role in the corporate decisions at issue in that case. The Court then went on to consider whether other directors who were *not* subject to any likelihood of liability and therefore were not "interested" would nevertheless be disqualified from properly considering a demand because they were not independent of the interested directors. The Court quoted *Aronson* for the proposition that "independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993). Under this test, "[t]o establish lack of independence, [plaintiff] must show that the directors are 'beholden' to the Rales brothers or so under their influence that their discretion would be sterilized." *Id.* The Court held that management directors, whose livelihood depended on the Rales brothers' good graces, were not independent under this test.

The other cases plaintiffs cite (at 15 n.7) all follow the same pattern. For example, in *In re The Limited, Inc. Shareholders Litig.*, 2002 Del. Ch. LEXIS 28 (Del. Ch. Mar. 27, 2002), the court applied the *Aronson* test in evaluating whether plaintiffs could proceed with a shareholder derivative action challenging a self-tender transaction. The court stated that to meet the first prong of *Aronson*, "a plaintiff must plead particularized facts sufficiently demonstrating that the defendant directors had a financial interest in the challenged transaction, that they were motivated by a desire to retain their positions on the board or within the company (an entrenchment motive), or *that they were dominated or controlled by a person interested in the transaction*." *Id*. at *12 (emphasis added). Applying this standard, the court first considered whether any director was interested in the transaction. It concluded that the chairman and CEO stood to obtain a personal financial benefit from the self-tender that was not equally shared by the shareholders and thus was interested. The court then considered whether the other ten directors, none of whom had a personal interest in the transaction, were so beholden to the CEO that there was a reasonable doubt about their ability to make an independent decision in the best interests of the company and the shareholders. Not surprisingly, the court concluded that the directors who worked for The Limited and were the CEO's subordinates were not independent under this test.

In this case, too, the first step in the analysis is to determine whether plaintiffs have pleaded facts showing that any of the directors had a personal interest in the R&H transaction that was not aligned with the company's interests. Plaintiffs have not even attempted to meet that burden. Plaintiffs do not allege that any of the directors — including the "nonindependent" directors — stood to gain any personal benefit from entering into the agreement to acquire R&H. Thus, there is no reason to believe that any of the directors acted based on any motivation other than a desire to do what was right for Dow and its shareholders.

The only supposed "conflict of interest" plaintiffs can muster is the fact that Mr. Liveris served as a director on the Citigroup Board. Plaintiffs note that Citigroup was the lead administrative agent on the $13 billion bridge loan facility, but do not even attempt to explain how any alleged conflict of interest relating to the financing arrangements for the bridge loan could possibly have affected Mr. Liveris' judgment as to whether or not to enter into the R&H agreement in the first place.[7] Plaintiffs do not and could not sensibly claim that Mr. Liveris' decision to recommend the R&H transaction was influenced in any way by a desire to provide Citigroup with an opportunity to be part of a consortium of nineteen banks that would provide bridge financing for the transaction. And plaintiffs' own argument (at 14) about the extent to which Mr. Liveris is dependent on continued employment at Dow demonstrates that there is no possible basis for questioning his loyalty to Dow. *See Brehm v. Eisner*, 746 A.2d at 257 (upholding this Court's determination that Disney's CEO was not "interested" in the Ovitz contract in light of his economic interest in ensuring that the value of his Disney stock and options was not diluted).

Plaintiffs have failed to identify any "extraneous considerations or influences" that could have led *any* of the Dow directors, whether "independent" of management or not, to

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7 Paragraph 125(f) of the complaint suggests that Mr. Liveris might have had a conflict of interest if R&H had succeeded in forcing Dow to draw down on the bridge facility to close the deal and Dow had gone into bankruptcy as a result. Obviously, that did not happen. In any event, the alleged "conflict" appears to relate to decisions the Dow Board made in 2009 after the K-Dow transaction did not close — decisions that plaintiffs are not challenging in this lawsuit.

vote on the R&H transaction based on anything other than "the corporate merits of the subject before the board." *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984). Accordingly, they have failed to state a claim under *Aronson's* first prong and the Court need not, and indeed should not, consider plaintiffs' claims that Mr. Liveris dominated or controlled other directors. *See Brehm v. Eisner*, 746 A.2d at 258 (holding that where there is no director who is interested in the transaction in question, there is no need to consider the independence of the remaining directors).[8]

B. Plaintiffs Have Failed To Plead Demand Futility Under *Aronson's* Second Prong.

Plaintiffs have also failed to meet the second *Aronson* prong. Plaintiffs do not quarrel with defendants' articulation of the standards that apply to such a claim. *See* Defts. Opening Br. at 15-16. Thus, plaintiffs concede that they cannot meet their burden by attacking the substantive terms of the transaction approved by the Board. Instead, the only way plaintiffs can prevail under the second *Aronson* prong in a case like this, where the transaction was approved by a majority of disinterested and independent directors, is by pleading particularized facts showing that the *process* by which the Board's decision was made was so flawed that it raises a reasonable doubt about whether the Board acted in good faith. *See Brehm v. Eisner*, 746 A.2d at 259, 264.

This Court's decision in *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275 (Del. Ch. 2003), which plaintiffs quote at length at page 12 of their brief, illustrates the type of allegations necessary to meet this requirement. In *Disney*, plaintiffs alleged facts which, if true, showed that the Disney board had "failed to exercise *any* business judgment and failed to make

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[8] As demonstrated below, in any event, plaintiffs have failed to allege particularized facts raising a reasonable doubt about the other directors' independence from Mr. Liveris.

any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders." *Id*. at 278 (emphasis in original). Plaintiffs alleged that the Board and its Compensation Committee had "each spent less than an hour" reviewing whether Michael Ovitz should be hired to be President of Disney. In addition, plaintiffs alleged that

> neither the Old Board nor the compensation committee reviewed the actual draft employment agreement. Nor did they evaluate the details of Ovitz's salary or his severance provisions. No expert presented the board with details of the agreement, outlined the pros and cons of either the salary or non-fault termination provisions, or analyzed comparable industry standards for such agreements. Notwithstanding this alleged information vacuum, the Old Board and the compensation committee approved Ovitz's hiring, appointed [his good friend] Eisner to negotiate with Ovitz directly in drafting the unresolved terms of his employment, never asked to review the final terms, and were never voluntarily provided those terms.

Id. at 288. All of these facts related to the adequacy of the *process*, not the substantive merits, of the decision to hire Ovitz. This Court concluded that "all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury and loss." *Id*. at 289 (emphasis in original). It was in light of that extreme situation that the Court concluded that plaintiffs had carried their burden of alleging demand futility under the second *Aronson* prong. *See also Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009) (noting that "[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties").

Unlike the plaintiffs in *Disney*, plaintiffs here have not alleged any facts that call into question the process the Dow Board followed in considering and approving the R&H transaction. There are no allegations that the Dow Board failed to put in the time and effort necessary to properly evaluate the risks and benefits of that transaction, nor is there any claim that the Dow Board was unaware of material terms of the transaction or failed to obtain the advice of experts before deciding to approve it. Under those circumstances, the Dow Board is entitled under *Aronson* to a presumption that it "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation." *Aronson*, 473 A.2d at 812. That presumption makes it impossible for plaintiffs to prevail on the second *Aronson* prong.

In their response, plaintiffs insist that they have challenged, not only the wisdom of the Board's decision, but also the process by which that decision was made. Their explanation as to why their allegations should be read as being directed to process rather than substance, however, is sheer nonsense:

> Plaintiffs do, indeed, attack the Board of Directors for the woefully inadequate *process*, and lack of acting properly on what they must have learned through due diligence, in connection with the K-Dow and R&H transactions. The fundamental wrong complained of is that Defendants, including the Board of Directors, caused Dow to enter into an unconditional agreement to purchase R&H knowing that the transaction was financially dependent on a non-binding deal with Kuwait . . . .

Pl. Br. at 20 (emphasis in original). While plaintiffs say they are challenging the process the Board followed, in the very same sentence they assume that the Board conducted due diligence *and* learned all of the information that plaintiffs now say was material to their decision-making process. Thus, when plaintiffs say the Board failed to "act properly" on the information it had learned, they are not attacking the *process* the Board followed; instead, they are saying that the Board exercised poor business judgment. That is precisely the kind of second-guessing of the *substantive merits* of a business decision that the business judgment rule prohibits. *See Citigroup*, 964 A.2d at 122 ("whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degree of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational’, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests”).

Equally unavailing are plaintiffs’ protestations (at 20-21) that they are not seeking to second-guess Board decisions by using 20-20 hindsight. Defendants argued that, in July 2008, the directors had every reason to believe that Dow would be able to close the R&H deal whether or not the K-Dow transaction closed first. Plaintiffs respond by asking, if there were no concerns about the R&H closing, “why did Liveris and Merszei (with the Board’s approval) feel a need to conceal and misrepresent the dependence of the R&H merger on the K-Dow transaction?” This argument is utterly circular, as it *assumes* that there was a misrepresentation even though, as demonstrated above, plaintiffs have offered no factual basis for that claim. The press statements plaintiffs quote make it clear that Dow believed in July 2008 (when the R&H merger agreement was signed) that the $13 billion bridge loan it had negotiated would enable it to close the R&H transaction and still maintain its investment grade rating even if K-Dow did not close in time. As it happened, dramatic and unanticipated changes in the world economy made it impossible for Dow to take advantage of those back-up financing arrangements when the K-Dow transaction did not close. Plaintiffs may disagree with the directors’ decision to approve the unconditional R&H agreement given the financing alternatives Dow had available to it. But a quarrel over the merits of that decision cannot possibly provide a basis for accusing the disinterested, independent Board of acting in bad faith.

Once again, this Court’s decision in *Citigroup* is dispositive. As the Court explained, “hindsight bias” would make it impossible for any judge or jury to “properly evaluate whether corporate decision-makers made a 'right' or 'wrong' decision" in taking certain risks in order to achieve a particular goal. 964 A.2d at 124. Moreover, allowing such second-guessing would be directly contrary to the fundamental purpose of the business judgment rule, which is to "allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly." *Id*. at 125.

Plaintiffs attempt to distinguish *Citigroup* on the ground that in that case plaintiffs were "suing the directors, in essence, simply for exercising their business judgment." Pl. Br. at 33. Yet that is precisely what plaintiffs are doing here. Plaintiffs argue that this case is different because it involves a "single egregious 'bet the company' transaction." But it is with respect to "bet the company" transactions that the protections of the business judgment rule are most needed: if directors have to face the specter of being held personally liable if shareholders claim that a transformational transaction turned out badly, the end result will be that directors will be reluctant to pursue such transactions, foregoing the benefits such transactions may create for the company out of fear of the personal risks they might entail.

Plaintiffs also attempt to distinguish *Citigroup* on the ground that the Citigroup directors were accused of failing to recognize business risk, rather than failing to uncover fraud or criminal conduct. Plaintiffs once again assert their claims of misrepresentations and their unsupported allegations about bribery in Kuwait in an attempt to make this a case about an alleged failure to uncover misconduct, rather than about the evaluation of business risk. In so arguing, plaintiffs ignore the fact that in *Citigroup*, the plaintiffs also accused management of making misrepresentations and engaging in other misconduct. But that did not change this Court's focus in evaluating whether plaintiffs had properly pleaded demand futility with respect to their primary claim that the Citigroup directors had failed to recognize the coming subprime storm. Because plaintiffs there were attacking business judgments made by the board, the Court applied the business judgment rule. This is an even clearer case for the application of the rule, because here plaintiffs are attacking the wisdom of a corporate transaction that the Board unanimously approved. No matter what other claims plaintiffs may make, they cannot obscure the fact that they are seeking to second-guess a business judgment made by disinterested, independent directors who must be presumed to have been fully informed — an enterprise that *Aronson* and its progeny expressly prohibit.

III. PLAINTIFFS HAVE ALSO FAILED TO MEET THEIR BURDEN OF PLEADING DEMAND FUTILITY UNDER *RALES*.

The parties agree that *Rales* applies to the extent plaintiffs are pursuing claims against the Board for allegedly failing to supervise management's conduct. In their brief, however, plaintiffs appear to be trying to get two bites at the demand futility apple by analyzing the Board's decision to approve the R&H transaction under *both Aronson* and *Rales*. *See, e.g.*, Pl. Br. at 25. As this Court held in *Citigroup*, however, *Aronson* applies to board action, whereas *Rales* applies to board inaction, such as a claimed breach of the duty to supervise. Thus, *Rales* simply does not apply to plaintiffs' claims arising out of the approval of the R&H transaction. In any event, as demonstrated below, even if *Rales* could be applied in this context, plaintiffs have not pleaded particularized facts showing that the directors face a substantial likelihood of liability for their decision to proceed with the R&H transaction.

A. Plaintiffs' Claims That There Were "Red Flags" Surrounding The R&H Transaction Do Not Establish Demand Futility Under *Rales*.

Throughout their response, plaintiffs repeatedly argue that they have pleaded "abundant facts constituting 'red flags' that would have alerted conscientious directors that the R&H Merger faced a material risk of financial collapse." *See, e.g.*, Pl. Br. at 21, 29 n.10.

Plaintiffs then try to force this case into the mold of a *Caremark* claim, citing numerous cases where courts have considered whether the directors' alleged failure to recognize "red flags" indicating the possibility of misconduct is enough to give rise to a substantial likelihood of liability and therefore to excuse demand under *Rales*. For example, plaintiffs devote three pages of their brief to lengthy quotations from the transcript of Vice Chancellor Strine's bench ruling in *In re Marsh & McLennan Cos. Inc. Deriv. Litig.*, C.A. No. 753-VCS (Del. Ch. June 17, 2009). In that case, the plaintiffs brought derivative claims against Marsh's directors for failing to discover that Marsh had accepted "lavish commissions and other special payments" from insurance companies in violation of relevant insurance regulations. Pl. Br. at 21. The court concluded that the payments raised a red flag, which should have prompted directors to inquire into their propriety — to ask "[c]ould it be that this is coming about because we are doing things we shouldn't?" *Id*. Plaintiffs argue that in this case too there were red flags about the risks of the R&H transaction, which should have caused the directors to ask questions about whether they should proceed with the transaction.

In so arguing, plaintiffs ignore the distinction this Court made in *Citigroup* between claims that the directors failed to uncover *misconduct* on the part of management and claims that the directors failed to fully appreciate a *business risk*. As the Court explained, "[t]here are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk":

> While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. . . . To impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal*

> liability for failure to predict the future and to properly evaluate business risk.

964 A.2d at 131 (emphasis in original). The Court ended by noting that plaintiffs' argument that the directors had ignored "red flags" indicating that Citigroup was facing "excessive risk" from subprime lending "invit[ed] the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule." *Id*.[9] So too, in this case, plaintiffs' claim that the directors ignored "red flags" indicating that there was too great a risk that the R&H transaction could not be financed invites the "exact kind of judicial second-guessing that is proscribed by the business judgment rule."

B. Plaintiffs Have Failed to Plead Demand Futility Under *Rales* With Respect To Any Of Their Other Claims.

Once the Board's approval of the R&H transaction is eliminated, there is little left of plaintiffs' failure-to-supervise claim. Plaintiffs repeat their allegations that Dow management misrepresented the relationship between the K-Dow transaction and the closing of the R&H deal. But, as demonstrated above and in defendants' opening brief (at 29-31), plaintiffs have not alleged particularized facts to show either that (i) the statements in question were untrue at the time they were made or (ii) that the directors were responsible for those statements. Defendants' opening brief analyzed the directors' likelihood of liability for the claimed misstatements under the standards this Court adopted in *Citigroup*. Plaintiffs do not respond to that analysis. Instead, they simply continue to repeat their baseless assertions that the statements were false, the

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[9] The cases plaintiffs cite at pages 28-31 of their brief are also distinguishable because they all involved claims that the directors had failed to discover some type of management misconduct, whether it be violations of internal underwriting guidelines, accounting irregularities, regulatory violations or criminal misconduct. Unlike *Citigroup* and this case, none of those cases involved a claimed failure to recognize or appreciate allegedly excessive business risks. Accordingly, all of those cases are irrelevant to the analysis here.

directors must have known they were false, and that the directors therefore face a substantial likelihood of liability.

For the reasons described at the outset of this reply, the rest of plaintiffs' *Caremark* claims should be deemed waived. Plaintiffs' mere repetition of their assertion that the directors failed to "detect and prevent insider trading of Dow shares by the Insider Selling Defendants" is not enough to preserve that claim in the face of defendants' unanswered arguments showing that the insider trading claim is ludicrous on its face. Similarly, the continued assertion, without explanation or argument, that Dow paid excessive and wasteful compensation to unidentified officers and directors is not enough to sustain that claim.

Nor have plaintiffs offered any reason why the Court should allow them to pursue a claim against the directors for failing to prevent alleged bribery in connection with the K-Dow transaction. Once again, plaintiffs do not respond to the arguments that defendants made with respect to this claim. They offer no basis for believing that there was in fact any bribery. Plaintiffs' only source for that allegation is an unsubstantiated charge made by a member of the Kuwaiti Parliament. Plaintiffs do not try to defend the accuracy of those charges. On the contrary, their own description of the political dynamic in Kuwait makes it impossible to take the charge seriously. Plaintiffs describe Kuwait as an "unpredictable regime whose adherence to the rule of law [is] doubtful" and where there has been "[e]ndemic infighting" for more than a decade between the National Assembly (the source of the bribery rumors) and the Cabinet (which was blamed by some in Parliament for its involvement in the K-Dow transaction). Pl. Br. at 7; Compl. ¶ 79. *See also* Ex. E to Defts. Opening Br. (noting that the allegations "sound more like a part of the inter-factional smear campaigns that increasingly plague the country's parliament").

Plaintiffs also offer no explanation as to why the directors should have suspected that there might be misconduct with respect to the K-Dow transaction. Plaintiffs do not point to any "red flags" that would have suggested that Dow's management had engaged in bribery in connection with a high-profile, $9 billion transaction. Plaintiffs point to their allegation that in January 2007 officers of a Dow subsidiary in India paid $200,000 to Indian government officials to expedite pesticide registrations. Knowledge of that incident, however, would not cause a reasonable director to wonder about the conduct of different people (in this case, Dow's senior management) in a very different setting.

C. Plaintiffs Have Failed To Allege Particularized Facts Showing That Mr. Liveris Dominated Or Controlled The Board.

For all of the reasons outlined above, plaintiffs have failed to allege facts sufficient to show that any of the directors face a "substantial likelihood of liability" under the terms of Dow's Certificate of Incorporation for failing to properly supervise management's conduct.[10] Plaintiffs argue that, even if they have not shown that the outside directors face a substantial likelihood of liability, they have shown that Mr. Liveris does and have also alleged sufficient facts to raise a reasonable doubt about whether a majority of the directors are independent of Mr. Liveris. This argument should also be rejected.

First, for all of the reasons outlined above and in defendants' opening brief plaintiffs have failed to show that Mr. Liveris is subject to a substantial likelihood of liability.

[10] Plaintiffs complain (at 35) that Dow's certificate, which contains a Section 102(b)(7) provision, should not be considered on a motion to dismiss. It is well settled, however, that the Court can and should consider whether the plaintiffs have pleaded non-exculpated conduct in deciding whether plaintiffs have met their burden of showing a substantial likelihood of liability. *See Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006).

But even if plaintiffs had met that burden, they have failed in their effort to portray Mr. Liveris as dominating or controlling at least five other members of the Board.

As demonstrated in defendants' opening brief (at 24-27), plaintiffs' allegations of domination and control are woefully inadequate. In their response, plaintiffs simply repeat those allegations, without even attempting to respond to defendants' arguments as to why they are insufficient as a matter of law. Significantly, in the four pages they devote to this argument, plaintiffs do not cite a single case in which a Delaware court has concluded that domination and control has been properly pleaded based on the type of facts alleged here. Nor do plaintiffs acknowledge the heavy burden they must meet to establish domination or control. In *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004), the Court held that "[t]o create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of the relationship . . . the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director." *Id.* at 1052. For the reasons outlined in defendants' opening brief, plaintiffs have not come close to meeting that burden here.

IV. COUNT III OF PLAINTIFFS' COMPLAINT SHOULD ALSO BE DISMISSED.

In Count III of their complaint, plaintiffs seek to assert claims for contribution or indemnity against the Individual Defendants arising out of unidentified claims that might be asserted in the future against Dow. Plaintiffs do not contend that there are any claims currently pending against Dow that could give rise to a claim for contribution or indemnity. Nevertheless, they argue that it would be premature to dismiss their claim for contribution or indemnity under Rule 12(b)(6). The case plaintiffs cite for that proposition is completely inapposite. In *Daystar Construction Management, Inc. v. Mitchell*, 2006 Del. Super. LEXIS 286, at *41-42 (Del. Super.

July 12, 2006), the issue was whether a third-party complaint for contribution was ripe when the defendant/third-party plaintiff had been sued, but had not yet been found liable. The court held that the pendency of claims against the party seeking contribution was enough to allow the claim to survive. Here, by contrast, plaintiffs cannot identify any claim that is pending against Dow for which contribution could be sought. Accordingly, their claim for contribution or indemnity is clearly not ripe and should be dismissed under both Rule 12(b)(6) and Rule 23.1.

CONCLUSION

For the foregoing reasons and the reasons set forth in defendants' opening brief, the complaint should be dismissed. Plaintiffs have asked for leave to replead, but have not even attempted to explain how they would be able to supplement the deficient allegations of their complaint to properly plead demand futility. Accordingly, leave to replead should be denied.

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